

# THE CONSEQUENCES OF DEVOLUTION

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# 3. FISCAL IMPLICATIONS

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The focus of this chapter is upon the fiscal implications of devolution for the United Kingdom as a whole, as much as upon the devolved territories of Scotland, Wales and – perhaps in due course – Northern Ireland. Given that such devolution is still at the construction phase, predictions about the wider implications for the United Kingdom must necessarily be tentative, not least because of the breadth and depth of constitutional changes currently under discussion (see Ch. 2). In these circumstances, it is appropriate to inform readers that the present authors have been long-standing proponents of devolved government, particularly – but not exclusively – for Scotland. As such, they are participant observers.<sup>1</sup>

The chapter is structured in the following way. Financial mechanics are discussed, with particular attention to the role of the Barnett formula which will determine the size of the block grants to devolved administrations. Subsequently, attention turns to various dimensions of fiscal politics, an area which devolution might be expected to transform.

## Financial mechanics

The territorial allocation formula to which Joel Barnett's name has become attached did not seem sufficiently important to be mentioned in his memoirs of his 1974-79 ministerial career as Chief Secretary to the Treasury.<sup>2</sup> The first official acknowledgement of the existence of the Scottish block was in a written parliamentary answer on 14 April 1980.<sup>3</sup> George Younger, then Secretary of State for Scotland, subsequently explained the formula to the Committee on Scottish Affairs on 7 July 1980.<sup>4</sup>

There are now a number of published accounts of how the Barnett formula and territorial blocks have operated.<sup>5</sup> Giving evidence to the Treasury Committee on 13 November 1997, Lord Barnett refuted the proposition that the adoption of the Barnett formula in 1978 had been closely connected to then current plans for devolution.<sup>6</sup> Moreover, he regarded the formula's original justification as having been principally based on relative GDP per head, rather than on differences in expenditure need. This runs counter to the research literature. A possible reconciliation of these positions might be that officials in the Treasury and territorial departments were indeed concerned about devolution arrangements, whilst differences in GDP per head were the reason why Barnett was able to persuade the Cabinet of the merits of the formula approach. How much was understood in 1978 about the dynamic properties of the formula might not be known until the relevant Cabinet papers come into the public domain.

Briefly, the formula provided that increases in public expenditure in Scotland and in Wales for specific services within the territorial blocks would be determined

according to the formula consequences of changes in equivalent expenditure in England. Initially, Scotland received 10/85ths and Wales 5/85ths of the change in England. A parallel formula allocated 2.75% of the change in equivalent expenditure in Great Britain to Northern Ireland. The essential distinction is between base expenditure (whose current levels are carried forward) and incremental expenditure (which is determined by the formula). Under this arrangement, block expenditure relatives would in the long run converge on the UK per capita average; however, this has been substantially frustrated by formula bypass, and for Scotland by relative population decline. In 1992, the formula was recalibrated (10.66:6.02:100.00 and Northern Ireland 2.87%) in recognition of the results of the 1991 population census.

The constitutional debates in Scotland in the 1990s, initiated by the Scottish Constitutional Convention (SCC), began to attract more attention both to territorial expenditure relatives and to the formula itself. The third and fourth Secretaries of State for Scotland in the 1979-97 Conservative Government (Ian Lang and Michael Forsyth) began to flaunt Scotland's public expenditure relative as evidence of the 'benefits of the Union', especially when attacking the SCC's devolution scheme. In contrast, their predecessors (George Younger and Malcolm Rifkind) had defended the formula in private and downplayed the relative in public. In the run-up to the 1997 general election, Scottish Office ministerial speeches seemed to be informed by a scorched-earth policy, claiming that the present relative was unjustifiable and would be threatened by devolution. This tactic produced many statements which have been used against Scotland in political debate.<sup>7</sup>

The Labour Government's White Papers setting out devolution plans for Scotland and Wales<sup>8</sup> stated that the devolved bodies would be financed by block grant whose size would be regulated by the continuing application of the Barnett formula. Neither devolution Bill has any substantive provision about the determination of the block grant. The fact that this continuation of the formula is based upon Executive fiat was illustrated by the extensive publicity surrounding the Treasury Committee's evidence. Treasury civil servants, called upon to defend ministerial decisions about what is 'objective and fair', were given an uncomfortable ride. With a parliamentary majority of 179, the Labour Government can undoubtedly brush aside the discontent on its English backbenches, trying – in the words of Brian Sedgemore MP – to push the issue 'into the long grass':<sup>9</sup> 'We've told them to get stuffed', said a senior Government source, referring to the [report prepared by the] Treasury select committee.<sup>10</sup>

Even without a change of government at the general election due not later than 2002, a smaller second-term

Labour majority would provide much greater leverage to those disaffected about territorial expenditure allocation.

In the meantime, the Chief Secretary's 9 December 1997 written answer<sup>11</sup> about the future operation of the formula was interpreted as pre-empting the report which the Treasury Committee was scheduled to agree on 15 December 1997. The key passage read:

...the formula will be updated annually to take account of population changes and from time to time to take account of other technical changes. Any more substantial revision would need to be preceded by an in-depth study of relative spending requirements and would be the subject of full consultation between the devolved administrations and the UK Government.<sup>12</sup>

This population-updating change was essentially diversionary. What has limited the expected convergence from the operation of the Barnett formula has been continued falls in Scotland's relative population which serves as the denominator for the annual calculation of per capita relatives for identifiable public expenditure. The effect on relatives of annual changes to the basis for allocating the increments will be small, at the risk of politicising between-census population estimates issued by different government organisations.

### **Impact on Styles of Fiscal Politics**

Territorial expenditure mechanisms have been buried deep in bureaucratic recesses, and it seems likely that their full implications have been imperfectly understood. The arrival of devolution means that more transparency is inevitable, and this can either be accepted gracefully or begrudgingly. Indeed, debates on devolution in the 1990s probably made this inevitable, irrespective of whether constitutional reform stalled or went ahead. There are two obvious implications.

First, the real numbers will increasingly be in the public domain, and it will become much more difficult to fudge them. Indeed, as a result of the Treasury Committee hearing, relatives for block expenditure are now available, but only for 1995-96. For that year, block relatives (England = 100) constructed with reference to the coverage of their respective territorial blocks were: Scotland (132); Wales (125); and Northern Ireland (132).<sup>13</sup> (As the blocks differ in coverage, these relatives cannot be directly compared.) The evidence on data availability given by Treasury officials indicates that it is unlikely that the detailed operation of the Barnett formula over the past 20 years will ever be systematically documented.

Second, the adoption of the Additional Member System (AMS) for elections to devolved bodies in Scotland and Wales will have important repercussions upon fiscal politics. Whereas Labour might expect to win control of the Welsh Assembly, there is unlikely to be a single party majority in Scotland. There has long been an assumption that the first Scottish Parliament would see a Labour/Liberal Democrat coalition. Depending upon the arithmetic, there might instead be an anti-Labour coalition (SNP, Liberal Democrat and Conservative) or a unionist coalition (Labour, Liberal Democrat and Conservative). In the longer term, there might be pre-

election concordats, though initially it is more likely that there will be post-election coalition agreements. Such documents might indicate public expenditure priorities and the circumstances under which the tax-varying power would be used. This might bring both more transparency (it will be impossible to keep the contents of such agreements confidential) and less flexibility (Scottish Executives may be locked into agreements which, though rendered inappropriate by changed circumstances, would be too fraught to renegotiate). A key vulnerability for Labour in Scotland will be the concern that Labour Members of the Scottish Parliament (MSPs) would be controlled by the London-based party leadership, concerned about the spillover effects of Scottish spending and taxation decisions upon Middle England's perception of New Labour. Even before policy difficulties with the tartan tax led to the imposition upon Labour's Scottish leadership of the two-question referendum, Farquharson<sup>14</sup> had perceptively warned of the tension between Labour's devolution commitment and its centralised party management. Before the 1997 general election, the UK leadership decided that Scottish Labour MSPs would be bound by Tony Blair's promise not to raise either the basic or higher rate of income tax during the life of the 1997 Westminster Parliament.

### **Extent of Policy Diversity**

Expenditure-switching discretion over the territorial blocks might have led to greater policy diversity. However, Midwinter, Keating and Mitchell concluded that '[The Scottish Office] does not have real policy discretion'.<sup>15</sup> Two factors have been important. First, Conservative Secretaries of State for Scotland were members of UK Cabinets with a clear ideological view about the desirable nature of public sector reform, whose application to Scotland mostly differed in pace and style rather than substance. Second, the paucity of Scottish Conservative MPs encouraged the Government to attach Scottish sections to GB legislation, rather than suffer the discomfort of enacting separate Scottish Bills. The benefits from the block arrangements therefore largely accrued in terms of better expenditure management rather than policy divergence.

The constraints upon policy diversity under devolution will most likely relate to resource availability and to cross-border spillovers. With funding going through the Barnett formula, supported by only limited tax-varying powers, it will be difficult for the Scottish Executive to stand out against English reforms with large expenditure numbers attached (eg tuition fees for higher education). Another example concerns the reluctant use of the Private Finance Initiative within the National Health Service and for investment in the still publicly owned water and sewerage sector. If Labour were to be part of the Scottish Executive, there would be great nervousness that policy divergence would lead to controversy in England, either about the policy itself or about expenditure relatives. Internally within Scotland, the media has a well-developed habit of urging the customisation of UK policy to distinctive Scottish needs and then searching for those areas where a narrow comparison makes Scots look disadvantaged!

## Conclusions

Devolution will have far-reaching implications for the fiscal constitution of the United Kingdom. The Government's insistence that the Barnett formula continues, virtually unchanged, is challenged from two distinct positions. First, the Treasury Committee's call for a review of the formula is obviously linked to the opinion of some of its English members that Scotland has been pampered. Much of the UK media comment has been of this kind. Second, many of those who have contributed to the Scottish debates on the financing of devolved government have also called for such a review.<sup>16</sup> Writing in 1990, before the current devolution plans were formulated, Heald cautioned:

Although it would be unwise to guess at the detailed outcome of the Expenditure Needs Assessment Exercise, the Scottish Parliament would have to recognise the probability that the relative needs index would be lower than the actual relative. In such an eventuality, the design of the formula for a concomitant reduction of block grant over a period of years would be a critical issue.<sup>17</sup>

On the day before the Treasury Committee's Barnett hearing, *The Herald's* editorial advised:

The promise of transparent negotiations between the Scottish Executive and the UK Government conducted fairly on an up-to-date assessment of relative need offers the best way to take the sting out of the Barnett tail.<sup>18</sup>

The motivations of these Scottish devolutionists is that they would prefer to take any bad news early (when there is goodwill at Westminster and Whitehall towards the constitutional reform package) rather than later (when there might be a different administration and resentments may have built up). Warning examples from the Government's backbenches are becoming easy to find:

[would I] be correct in thinking that, as applied to the current situation, this means that the Government is in fact ruled by a Scottish hegemony that English Cabinet ministers cannot smash, and that is replicated in the Treasury because the

Chancellor, the Chief Secretary to the Treasury and the Economic Secretary to the Treasury are all Scottish MPs[?]<sup>19</sup>

The Labour left-winger Ken Livingstone implied that Scots were responsible for the rundown state of his city's underground system when he claimed that too much public money was being spent in Scotland instead of London.<sup>20</sup>

If a downward adjustment of public expenditure relatives is shown to be necessary, it needs to be planned for and implemented over a suitable transition period. There might well be a trade-off for the territories between seeking to protect existing expenditure relatives and securing a stable financial framework for devolved government.

The Government's devolution legislation has been criticised for not embodying a durable fiscal settlement.<sup>21</sup> The Government's response is essentially circular. The reasonable point, that the conduct of such an exercise should wait until the Scottish and Welsh Executives have been established, does not prevent the announcement of a needs assessment in, say, 2002. The only substantive point made by the Government reply to the Treasury Committee<sup>22</sup> was to repeat that the Scottish and Welsh referendums were fought on the basis of the undertakings in the respective devolution White Papers that the Barnett arrangements would continue and that revisions beyond updating would require both an in-depth study and consultation with the devolved administrations.

This situation has arisen because the pre-election commitment to having referendums, especially the two questions in Scotland, made the White Papers campaigning rather than reflective documents. Undoubtedly, the Labour Party is now nervous about elections to devolved bodies held in the Westminster mid-term. The worry from a devolutionist perspective is that the pretence that nothing has changed, currently sustainable because of the size of the Government's majority, will erode the mutual trust crucial to the viability of quasi-federal arrangements.

## References

### 3. Fiscal Implications

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